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ABSTRACT

Just 1 day before a court-imposed deadline of June 1, 1993, Texas Governor Ann Richards signed into law Senate Bill 7 (S.B. 7), the newest version of the Texas school finance system. This paper describes the state's new school finance system with regard to the following: (1) its constitutionality; (2) the provision of a system that equalizes school districts' capital outlay expenditures; (3) full funding of the equalization portion of the school finance system; and (4) the legal challenge to the adequacy of the school finance system. It also presents a historical overview of Texas school finance reform since 1984. Informed sources believe that S.B. 7 will survive constitutional scrutiny. However, the adequacy claim under the "suitable provision" portion of the education article (Texas Constitution, article VII, paragraph 1) may become a salient issue. The legislature must implement a reasonable and equitable funding mechanism for capital outlay. Perhaps the most important issue will be the availability of state revenues to fully fund the bill's equity provision. (LMI)

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Texas

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School Finance Policy Issues in Texas

- Constitutionality of new funding formula, Senate Bill 7, enacted in 1993
- Providing a system to equalize school districts' capital outlay expenditures
- Full funding of the equalization portion of the school finance system
- Legal challenge to the adequacy of the school finance system

Texas' New School Finance System

Just one day before a court-imposed deadline of June 1, 1993, Governor Ann Richards signed into law Senate Bill 7 (S.B. 7), the newest version of the Texas school finance system (Act of May 31, 1993, 73rd Leg., R.S. ch. 347, 1993). The new school finance law is the fourth since 1985. The three previous laws were found unconstitutional by the Texas Supreme Court and are discussed in the next section of this report.

Soon after S.B. 7 was enacted it too was challenged as unconstitutional by low-wealth districts as well as a group of property-rich districts. On December 9, 1993, the state district court upheld the constitutionality of S.B. 7 (Edgewood I.S.D. v. Meno, No. 362,516, 250th Dist. Ct., Travis Cty., Tex., December 9, 1993). The ruling has been appealed to the Texas Supreme Court, which has set oral arguments for May 25, 1994. Knowledgeable sources in Texas predict that the Texas Supreme Court will uphold the constitutionality of S.B. 7. The remainder of this report is based on the assumption that S.B. 7 will be found constitutional by the Texas Supreme Court.

The primary objective of S.B. 7 is to comply with the supreme court's requirement

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of "substantially equal access to similar revenue per pupil at similar levels of tax effort" (*Edgewood I.S.D. v. Kirby*, 777 S.W. 2d at 397). S.B. 7 provides a multi-tiered school finance system with four major components: the per-capita allotment, Tier 1 (basic allotment), Tier 2 (guaranteed yield), and Tier 3 (local enrichment). S.B. 7 retained the basic framework from previous legislation. The most significant change is found in the mandated equalized wealth level, which has been set at $280,000 per weighted average daily attendance (WADA). To meet this mandate requires some form of recapture of local property tax dollars or tax base from property-rich to the property-poor school districts.

The per-capita allotment is a per-pupil direct grant to each public school district under the provisions of the Texas Constitution (art. VII, § 5). The annual interest from the corpus of the Permanent School Fund and proceeds from constitutionally dedicated taxes constitute the available school fund, which is distributed annually to each school district on the basis of the prior year's average daily attendance (ADA). These funds are distributed to school districts without regard to their local wealth; however, the funds are offset against other state dollars so there is some degree of equalization. Budget balanced districts (i.e. those wealthy districts that do not received any state equalization aid) do receive the per-capita allotment. For Fiscal Year (FY) 1994, the per-capita allotment was about $350 per ADA.

Tier 1 provides a basic allotment of $2,300 per ADA at a mandated tax rate of $.86 (per $100 valuation) in 1993-94. The state's share is the difference between the basic allotment and the revenue collected locally; i.e. the local fund assignment. Each district

must collect its local fund assignment to participate in the foundation school program. The basic allotment for all districts is adjusted by the cost of education index; and for qualifying districts, a small district adjustment or a sparsity adjustment is applied.

Tier 2; i.e. the guaranteed yield program, is designed to allow property-poor districts to supplement the basic program at Tier 1 with a locally-determined tax rate that is equalized by the state. Wealthy districts may not receive funds under the guaranteed yield provisions. The state guarantees a yield of $20.55 per weighted pupil per penny of additional tax effort be d the $.86 required for the local fund assignment in Tier 1. However, the state limits its share of additional guaranteed yield to the taxes the districts levied in 1992-93, thus local tax effort above the 1992-93 level for 1993-94 is not equalized by the state. The guaranteed yield allotment may be used for any legal purpose, including capital outlay and debt service.

Tier 3; i.e. local enrichment, allows districts to provide additional local revenues from the local tax base to supplement the costs of their educational programs. There is no state equalization for local enrichment. The state has set a nominal tax rate of $1.50 (per $100 valuation) on a local district's total tax rate (maintenance and operation plus debt service). The $1.50 limit may be exceeded if needed to pay for certain bonded indebtedness approved and issued prior to specified dates. New debt issued is limited to $.50, requires approval from the Attorney General, and is within the $1.50 overall limit. The $1.50 may be exceed for debt service with voter approval.

The most significant equalizing feature of S.B. 7 was the establishment of a local

district equalized wealth level of $280,000 per pupil in weighted average daily attendance (WADA) and the requirement that no district's taxable wealth per WADA could exceed that level. The state provided five options in order for the wealthy districts to lower their wealth to $280,000 per WADA by September 1, 1993. These options included consolidating with another district, detaching and annexing property, purchasing WADA credit from the state, educating non-resident students, or consolidating tax bases with another district. Local voter approval was required for purchasing WADA credit, educating non-resident students, and consolidating tax bases. Without a doubt, the legislative decision to limit local property wealth to $280,000 per WADA should have the effect of partially reducing the equity disparity among the state's school districts. However, for political reasons, the legislature included a hold harmless provision that will reduce the full impact of the mandated equalized wealth level for the wealthy districts through FY 1994-95.

There were 99 districts in the state that had taxable value in excess of $280,000 per WADA and each district held an election during the fall of 1994 for the voters to determine an option or combination of options to reduce local wealth. Only one district elected to detach property to lower its wealth. Fifty-two districts approved the purchase of weighted attendance credits and 8 districts voted to educate non-resident students. Thirty-eight districts voted for a combination of the latter two options; i.e. purchasing WADA credits from the state and educating non-resident students. This form of local recapture should increase the equity of the school finance system. From the state's

perspective, however, the recapture provides from $300 to $400 million from local taxpayers each year to be used for equalization.

To fund the equalization portion of S.B. 7, the legislature appropriated $1 billion in new school funds for the 1993-95 biennium. However, the state has delayed payment of $250 million to the districts in a move to shift 25 percent of the increase to the next biennium. In order to compensate for this reduction, the legislature reduced the foundation program (Tier 1) guarantee from $2,400 per pupil in 1992-93 to $2,300 for the 1993-95 biennium. In addition, the required local tax rate for districts to participate in the foundation school program was increased from $.82 (per $100 valuation) to $.86. The guaranteed yield (Tier 2) was set at $20.55 per weighted pupil for each penny of tax effort, a reduction from the prior year's level of $22.50. To limit the state's financial commitment to Tier 2, the legislature provided that the guaranteed yield will be applied only up to the taxes collected in 1992-93. Therefore, no equalization funds are provided for the actual 1993-94 tax effort that is above that of the prior year. Given these changes, school districts, both property-rich and property-poor, will have to raise local taxes for different reasons to generate the same revenue for 1993-94 as they had in 1992-93. To compound the problem, the higher tax rates levied by these school districts for 1994-95 will set the standard for the tax effort to be used in the guaranteed yield (Tier 2) and tax roll-back calculations for the following biennium.

Current School Finance Policy Issues

There are several issues that could imperil the school finance system under S.B.

7. It remains to be seen whether the Texas Supreme Court will uphold the constitutionality of the law because of the continued variations in revenue per weighted pupil between the property-rich and the districts. The trial judge, Scott McCown, reasoned that the existing $600 gap was tolerable because of the small number of students involved, the progress that had been made in reducing wealth-related disparities, and the limited options (Edgewood I.S.D. v. Meno, No. 362,516, 250th Dist. Ct., Travis Cty., Tex., December 9, 1993, at 64-65).

Another salient issue is the future cost of equalization. It is estimated that the equalization features of S.B. 7 will require from $2.0 to $2.5 billion in new funds in the second biennium of the four-year implementation. In the political climate of an election year with pledges of "no new taxes", it is unlikely that substantial new state revenue will be available to support equalization efforts. Moreover, the local tax increases that occurred under S.B. 7 along with the limits placed on local tax rates could put districts in a precarious position with respect to providing adequate local funds to support their education programs.

In a constrained resource environment, the legislature could alter the provisions of S.B. 7 that would decrease state support. The result, however, would be an even greater burden on local taxpayers. There are, at least, six points in the school finance that are susceptible to change. For example, if legislature reduced the level of the basic allotment at Tier 1 from the current level of $2,300 per weighted pupil to $2,200, this would result in a savings of approximately $350 million to the state. The legislature could

increase the Tier 1 minimum tax rate, which currently is $.86 per $100 valuation. This would shift the burden of school finance away from the state to the local districts. While there is the possibility of reducing the level of equalized wealth a district is allowed to maintain, this level is not likely to be reduced lower than $265,000 per pupil, as that is the level that approaches Dallas Independent School District's valuation of $264,758. It would not be politically acceptable to leave Dallas with no equalization funds. In the Tier 2, guaranteed yield program, the legislature could reduce the number of pennies of local tax rate that would be equalized, or lower the limit of tax effort which would apply. The legislature could adjust or eliminate some of the formula elements; such as the cost of education index, the small district adjustment, student weights, and so forth. Finally, the tax caps could be eliminated. Any of these changes would result in no new state taxes, a situation that would satisfy state politicians, but the local tax burdens would become excessive.

School Finance History in Texas

School finance reform has preoccupied the legislative agenda in Texas since 1984, with four major school finance laws, three of which have been declared unconstitutional by the Texas Supreme Court and the fourth on appeal. The major impetus for reform occurred when a group of property-poor school districts challenged the existing school finance system in 1984, in a case filed originally as *Edgewood I.S.D. v. Bynum*. The plaintiffs challenged the school funding law as violating the state constitution's equal protection clause and the education article. The case never went to trial, but was refiled

a year later challenging reform legislation that had been enacted by the Texas Legislature in special session in the summer of 1984. The new school finance system was embodied in House Bill 72 [1984 Tex. Sess. Law Serv. 28 (Vernon)], a general education reform bill. The law provided major changes in the school finance system with the intent of providing greater equity in the distribution of state and local funds.

Notwithstanding legislative attempts to improve the equity of the school finance system under H.B. 72, the property-poor school districts in 1985 renewed their legal challenge from the previous year in the case restyled as *Edgewood I.S.D. v. Kirby.* In 1987, the school finance system was declared unconstitutional on the basis of equal protection clause and the efficiency provision of the education article in state district court [*Edgewood I.S.D. v. Kirby. No. 362,516, 250th Dist. Ct., Travis Cty., Tex. June 1, 1987).* After a reversal by the appeals court (761 S. W. 2d 859 [Tex. Ct. App. 1988], the Texas Supreme Court declared the law unconstitutional in a unanimous decision solely on the basis of the efficiency clause [777 S.W. 2d 391 (Tex. 1989)].

While *Edgewood* was on appeal and before the supreme court's decision, the legislature enacted Senate Bill 1019 [1989 Tex. Sess. Law Serv. 816 Vernon)]. S.B. 1019 augmented the equalization provisions of H.B. 72 increasing the second-tier guaranteed yield program, which had been added on top of the foundation program in 1984.

After the Texas Supreme Court's decision in *Edgewood* in 1989, the legislature faced a May 1, 1990, court-ordered deadline to reform the school finance system. After protracted special legislative sessions, and after the expiration of the court's deadline, the

legislature enacted Senate Bill 1 (Act of June 7, 1990, 71st Leg., 6th C.S. ch 1, 1990 Tex. Gen. Laws 1). S.B. 1 made numerous changes in the school finance system to improve equity including an increase in state funding.

S.B. 1 failed to satisfy the *Edgewood* plaintiffs, who returned to court where the law was struck down [*Edgewood I.S.D. v. Kirby, (No. 362,516, 250th Dist. Ct., Travis Cty., Tex. September 24, 1990).* The Texas Supreme Court affirmed the district court's ruling that the law was unconstitutional [804 S.W. 2d 491 (Tex. 1991)].

In response to the supreme court's decision, the legislature enacted House Bill 351 (Act of April 11, 1991, 72nd Leg., R.S. ch. 20, 1991 Tex. Gen. Laws 381, *amended by* Act of May 27, 1991, 72nd Leg., R.S. ch. 391, 1991 Tex. Gen. Laws 1475). H.B. 351 retained the major framework of the school finance system under S.B. 1, but created County Education Districts (CEDs) to raise local taxes and redistribute the revenue among the member school districts as a method of local recapture. Not surprising, H.B. 351 also was challenged by both property-poor as well as property-rich districts. In *Edgewood I.S.D. v. Meno*, the state district court ruled that the new law was constitutional (No. 362,516-A, 250th Dist. Ct., Travis Cty., Tex., August 7, 1991). The Texas Supreme Court granted five direct appeals from judgments in three district courts. The court reversed the judgment on the grounds that the taxes levied and collected by the CEDs were state property taxes and violated the state constitution's provision barring state ad valorem taxes [Carrollton-Farmers Branch I.S.D. v. Edgewood I.S.D., 826 S.W. 2d 489 (Tex. 1992)].

After failing to enact a new school finance plan in a special session following the November 1992 general election, the next legislature in the regular session in 1993, called a state-wide referendum relating to the school issue. The major proposition called for making the CED tax system under H.B. 351 constitutional. On May 1, 1993, Texas voters rejected the referendum in a landslide negative vote. Within the month, and just a day before the court-imposed deadline, the legislature adopted S.B. 7. Judge McCown, who had jurisdiction of the case, opined that the law was constitutional until challenged and allowed it to go into effect. The appeal to the Texas Supreme Court is based on numerous claims, according Dr. Catherine Clark, Director, Texas Center for Educational Research, including (1) whether the state makes adequate provision for education through the finance system, (2) whether districts have a constitutionally protected right to the property within their boundaries and the tax revenue that property generates, (3) whether the state system of finance overly relies on the property tax, (4) whether the recapture options are constitutional, and (5) numerous other matters, such as voting rights and situs.

Conclusion

It remains to be seen whether S.B. 7 will survive constitutional scrutiny by the Texas Supreme Court, but informed sources believe that it will. However, there are other issues to confront the legislature and the courts. The adequacy claim under the "suitable provision" portion of the education article (Tex. Const. art. VII, § 1) may become a salient issue. The legislature must implement a reasonable and equitable funding mechanism

for capital outlay. Perhaps, the most important will be the availability of state revenues to fully fund the equity provisions of S.B. 7. The one thing that is assured is the continuation of litigation.